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Summary:

Energy Northwest, Washington Bonneville Power Administration, Oregon; Wholesale Electric

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Rationale

Standard & Poor's Ratings Services revised to negative from stable the outlook on the Energy Northwest (ENW), Wash.'s revenue bonds and the several nonfederal debt obligations that the Bonneville Power Administration (BPA), Ore. pays as operating expenses of its electric system. The outlook revision reflects the negative outlook assigned to the debt of the U.S. federal government (AAA/Negative/A-1+). At the same time, Standard & Poor's affirmed its 'AA' long-term rating on the nonfederal debt that BPA supports.

BPA has entered into agreements that we understand require it to treat debt service on its $6.5 billion of nonfederal debt as an operating expense. BPA pays nonfederal debt ahead of servicing $6.9 billion of federal debt.

BPA's nonfederal obligations include:

- $5.9 billion of ENW revenue and refunding bonds;
- $122.4 million of Public Utility District No. 1 of Lewis County, Wash., Cowlitz Falls Project bonds;
- $119.6 million of Northwest Infrastructure Financing Corp. (Schultz-Wautoma project) bonds;
- $22.8 million of Northern Wasco Public Utility District, Ore. (McNary Dam Project) bonds;
- $13.7 million of conservation and renewable energy system bonds; and
- $8.1 million of Tacoma, Wash., conservation system project bonds.

The 'AA' ratings on BPA and its nonfederal debt reflect the application of our government-related entities criteria (GRE) to BPA. We believe that BPA's stand-alone credit profile is 'aa-' and there is a "moderately high" likelihood that the U.S. government (AAA/Negative/A-1+) would provide extraordinary support to BPA in financial distress. We base the latter view on our opinion of the "strong" link between the BPA and the federal government as well as the "important" federal role the BPA plays in the Pacific Northwest. Our view of U.S. government support lifts the debt ratings above the stand-alone credit profile. Consequently, we believe that ratings on the nonfederal debt that BPA supports could decline if the federal government's debt rating is lowered.

The GRE rating reflects our view of:

- BPA's status as a federal agency;
- The ongoing financial support the federal government provides to the agency through long-term loans and credit lines;
- Legislation that allows BPA to defer repayments of federal obligations in periods of financial distress; and
- The utility's important contributions to the Pacific Northwest's economy, where it indirectly serves about 12 million electric customers in seven states, provides low-cost power that is critical to the region's economic health, and operates key transmission resources.

BPA's stand-alone credit profile reflects our assessment of the following factors:

- The ongoing support the federal government provides to BPA through loans and credit lines;
- Congress' $3.25 billion (or 73%) increase in the agency's federal borrowing authority in 2009;
- The legislative mechanism that allows BPA to pay nonfederal debt as an operating expense ahead of federal debt service and to defer repaying federal obligations if it lacks the financial resources to meet all of its operating and debt obligations;
- A track record of strong, but declining, coverage of nonfederal debt service of at least 1.8x in the past five fiscal years;
- The utility's exceptionally broad and diverse service territory;
- The strong, efficient, and economical operations of the 31 dams comprising the Federal Columbia River Power System (FCRPS) produce attractively priced hydroelectric power that fosters strong demand for the output of the combined FCRPS hydroelectric projects and ENW nuclear production;
- Robust liquidity, which tempers the impact of variable hydrology conditions on financial performance and mitigates credit risks inherent in biennial rate cases; and
- New 20-year contracts between BPA and its customers, which demonstrate the customer base's commitment to the agency's system. However, the new contracts do not establish rates and the utility will rely on rate proceedings.

Although we believe debt service coverage of federal and nonfederal obligations was inadequate in 2009 and 2010 because poor hydrology conditions and low wholesale electric prices eroded surplus power sales revenues and financial performance, we also believe robust liquidity provided a cushion that tempered the financial implications of these pressures.

Standard & Poor's also incorporates the following exposures in the ratings:

- Financial performance hinges on hydrology conditions that can impair surplus power sales revenues and can require replacement power purchases that add to expenses. Due to poor hydrology, accrual debt service coverage of nonfederal and federal debt was only 0.8x in 2009 and 2010, and 0.9x on a cash basis. BPA's cash from operations was $268 million in 2009 and $370 million in 2010, representing the lowest points in the past five years' cash from operations.
- Highly politicized and protracted biennial rate proceedings can delay rate relief and constrain the benefits of autonomous ratemaking authority and financial flexibility. BPA implemented current rates in October 2009 and has not revised rates to reflect poor hydrology conditions. In November 2010, BPA commenced rate proceedings to set rates for fiscals 2012-2013. BPA expects the new rates will take effect in October 2011.

- Weak prices in competitive wholesale power markets, like those of 2009 and 2010, compromised revenues from surplus energy sales and financial performance.
- BPA and ENW project substantial capital needs that could add to both organizations' debt.

BPA markets electricity generated at 31 federal hydroelectric projects; ENW's nonfederal, nuclear Columbia Generating Station; and several nonfederal small power plants. It also operates an extensive transmission system that facilitates power marketing activities. Its transmission system represents about 75% of the Pacific Northwest's transmission capacity.

The agency treats debt service on its $6.5 billion of nonfederal debt as an operating expense. It pays nonfederal debt ahead of debt service on nearly $6.9 billion of federal debt. Federal debt includes bonds issued to the U.S. Treasury and federal appropriations that BPA must repay with interest. The nearly 1-to-1 ratio of nonfederal-to-federal debt facilitates what we consider sound debt service coverage of the nonfederal bonds as long as rates meet all financial obligations.

BPA can defer its federal debt payments if, after paying operating expenses (which include nonfederal debt service), it cannot meet its total obligations. However, in the first instance, the utility is legally required to establish rates that it projects will cover all operating expenses, and federal and nonfederal obligations. Moreover, interest accrues on federal debt repayments that BPA defers. BPA's last deferral was in 1983.

In the event of financial shortfalls that exceed defined thresholds, the utility can use a cost-recovery, rate-adjustment mechanism that enables it to make limited rate adjustments without initiating protracted rate proceedings. Otherwise, BPA revisits base rates every two years.

Approximately 80% of the power the utility sells is hydroelectric. Its hydroelectric resources' performance hinges on hydrology conditions; they were 18% below the 30-year historical average in 2009, and 2010 flows were about 6% lower than in 2009. For fiscal 2011, Bonneville cites the National Weather Service's River Forecasting Center's forecast that indicates expected January - July flows will be 109% of the 30-year average. Even with average water flows, low market prices for surplus market sales can impair financial performance as was the case in fiscals 2009 and 2010. Natural gas prices, water quantities, and economic activity levels are some of the factors that can influence market power prices. BPA believes that prevailing low market prices will temper the 2011 projections of improved water flows and necessitate further draws on cash reserves.

BPA has committed to pay for the output of ENW's single operating nuclear plant and the debt of two other unfinished nuclear plants. Nuclear electricity production accounts for about 9%-12% of electricity sales. The lower end of this range reflects years with refueling outages. The Columbia Generating Station's license expires in December 2023 and ENW applied to extend the license for 20 years. ENW expects the Nuclear Regulatory Commission to rule on the extension application in 2012. It is uncertain whether recent nuclear developments in Japan will have implications for the relicensing application.

The Columbia Generating Station nuclear plant had five unplanned shutdowns in 2009. Although performance improved in 2010, we still view 2009's repeated outages as creating the potential for higher costs at a utility that only revisits base rates every two years. Nevertheless, BPA's unconditional obligation to service ENW's debt, the priority of nonfederal debt service over federal debt service, and strong liquidity mitigate some of our concerns.

Because one nuclear plant, Columbia, also supports the debt of two nonoperating nuclear plants, it is our view that the resulting debt per kilowatt (kW) for the station's 1,157 megawatt capacity is very high at more than $5,000 per kW. The debt burden would be lower but for the BPA-initiated debt optimization program. This program reduced the agency's overall debt obligations by accelerating some federal debt while deferring ENW debt for payment in later periods.

We believe the combination of low-cost FCRPS hydroelectric production and the nuclear plant's generally sound operations let BPA maintain attractive wholesale rates for its customers. The current rate for preference customers is about 2.8 cents per kilowatt-hour for FCRPS and ENW power. These rates were implemented in October 2009 and BPA projects they will remain in effect through September 2011, even though it faces poor hydrology conditions.

BPA's pending rate proposals contemplate tiered customer rates. The first tier would reflect the cost of FCRPS and ENW energy allocated to customers and limited supplemental market power. A second tier would reflect market prices for energy needs beyond FRCPS and ENW capabilities. The tiered rate structure focuses on providing equitable cost allocation among customers by requiring BPA's fastest-growing customers to shoulder costs of securing additional energy and capacity resources to meet customers' needs. This rate structure should shield slower growth customers from socialized costs. The tiered structure should be revenue neutral to BPA. A number of customers are challenging the revised rate structure in legal proceedings.

We believe accrual coverage of nonfederal debt service was very strong in 2005-2008, equaling at least 4.3x. In 2009 and 2010, coverage of nonfederal debt was markedly weaker, at 2.2x and 1.8x. Nonfederal debt service coverage in 2009 and 2010 reflected what we view as poor hydrology conditions and weak natural gas prices that eroded wholesale market prices for the surplus electricity available for sale. Consequently, accrual coverage of combined federal and nonfederal debt service fell to what we consider to be an inadequate 0.8x in 2009 and 2010. However, more than $1.1 billion of unrestricted cash and investments provided a sound cushion pending the outcome of BPA's rate proceedings. Fiscal year-end 2010 unrestricted cash and investments represented more than five months' operating expenses.

In February 2009, federal stimulus legislation raised BPA's debt ceiling by $3.25 billion to $7.70 billion. As the agency adds more federal debt and nonfederal debt amortizes, the budgetary directive that it cover all of its debt and expense obligations should translate into stronger coverage of nonfederal obligations.

Outlook

The negative outlook reflects our view that a lower rating of the federal government could erode the potential for extraordinary federal credit support for BPA during periods of financial distress. Moreover, exposure to hydrology conditions and wholesale markets could potentially erode BPA's stand-alone credit quality and, in turn, its government-related enterprise rating, particularly if cash basis coverage below 1x recurs and its robust liquidity cushion erodes meaningfully.

Related Criteria And Research

- General Criteria: Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- USPF Criteria: Electric Utility Ratings, June 15, 2007

Ratings Detail (As Of April 27, 2011)		
Energy Northwest, Washington		
Bonneville Pwr Admin, Oregon		
Energy Northwest elec rev rfdg bnds ser 2005 A & taxable ser B dtd 05/26/2005 due 07/01/2008 2013-2018		
Long Term Rating	AA/Negative	Outlook Revised
Energy Northwest proj 1, Columbia Generating Sta, & proj 3 elec rfdg		
Long Term Rating	AA/Negative	Outlook Revised
Energy Northwest proj 1, Columbia Generating St, & proj 3 elec rev rfdg bnds (Bonneville Pwr Admin) ser 2006 A-D		
Long Term Rating	AA/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) proj 3 elec rev rfdg bnds var rate subseries F-1 (Bonneville Pwr Admin) ser 2008-F dtd 06/17/2008 due 07/01/20		
Long Term Rating	AA/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) proj 3 elec rev rfdg bnds var rate subser F-2 (Bonneville Pwr Admin) ser 2008-F dtd 06/17/2008 due 07/01/2018		
Long Term Rating	AA/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) rfdg rev bnds (Bonneville Pwr Admin-Nuclear Proj #1 & #3) ser 1993C dtd 09/01/1993 due 07/01/1996 1999 2002-20		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) Sub Lien		
Long Term Rating	AA/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) (MBIA) (AGM)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) (Nuclear Proj 1,2,3)		
Long Term Rating	AA/Negative	Outlook Revised
Bonneville Pwr Admin elec rev rfdg bnds ser 2005 A & taxable ser B dtd 05/26/2005 due 07/01/2008 2013-2018		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Bonneville Pwr Admin elec rev rfdg (Colu)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Energy Northwest rfdg elec rev bnds (Bonneville Pwr Admin)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Energy Northwest (Bonneville Pwr Admin) (XL Capital Assurance Inc.)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Washington Pub Pwr Supp Sys (Nuclear Proj #3) rfdg rev bnds ser 93C dtd 9/23/93 due 7/1/2013 2014 2015 2017(CUSIP #939830RW7 RY3 RX5 RZ0)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Washington Pub Pwr Supp Sys (Nuclear Proj #3) (Bonneville Pwr Admin)		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Lewis Cnty Pub Util Dist #1, Washington		
Bonneville Pwr Admin, Oregon		
Lewis Cnty rev rfdg bnds (Bonneville Pwr Admin) (Cowlitz Falls Hydroelectric Proj) ser 2003 dtd 07/16/2003 due 10/01/2007-2012		

Ratings Detail (As Of April 27, 2011) **(cont.)**		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Lewis Cnty (Bonneville Pwr Admin) rev rfdg bnds (Cowlitz Falls Hydroelectric Proj) ser 2003 dtd 07/16/2003 due 10/01/2013-2024		
Unenhanced Rating	AA(SPUR)/Negative	Outlook Revised
Northern Wasco Cnty Peoples Util Dist, Oregon		
Bonneville Pwr Admin, Oregon		
Northern Wasco Cnty Peoples Util Dist (Bonneville Pwr Admin) (McNary Dam Fishway Hydroelec Proj)		
Long Term Rating	AA/Negative	Outlook Revised
Northwest Infrastructure Financing Corp., New York		
Bonneville Pwr Admin, Oregon		
Northwest Infrastructure Financing Corp. (Bonneville Pwr Admin) TRANs		
Long Term Rating	AA/Negative	Outlook Revised
Tacoma, Washington		
Bonneville Pwr Admin, Oregon		
Tacoma (Bonneville Pwr Admin) (Pub Util Lt Div Conserv Sys Proj)		
Long Term Rating	AA/Negative	Outlook Revised

Many issues are enhanced by bond insurance.

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